INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	6
Conclusion	10
Appendix	11

CITATIONS

Cases:	
Air-Way Electric Appliance Corp. v. *Guitteau*, 123 F. 2d 20	9
Amalgamated Housing Corp. v. *Commissioner*, 37 B. T. A. 817, affirmed, 108 F. 2d 1010	8
American National Co. v. *United States*, 274 U. S. 99	7
Bonded Mortgage Co. v. *Commissioner*, 70 F. 2d 341	9
Brown v. *Helvering*, 291 U. S. 193	6, 8
Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359	8
Clay Sewer Pipe Ass'n v. *Commissioner*, 139 F. 2d 130	8
Dixie Pine Co. v. *Commissioner*, 320 U. S. 516	6, 7
Heiner v. *Mellon*, 304 U. S. 271	8
Lucas v. *American Code Co.*, 280 U. S. 445	6, 7
Lucas v. *Ox Fibre Brush Co.*, 281 U. S. 115	6, 7
North American Oil v. *Burnet*, 286 U. S. 417	8
Ohmer Register Co. v. *Commissioner*, 131 F. 2d 682	9
Security Mills Co. v. *Commissioner*, 321 U. S. 281	6, 8, 10
United States v. *Amalgamated Sugar Co.*, 72 F. 2d 755	9
United States v. *Anderson*, 269 U. S. 422	6
Statute:	
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 22	11
Sec. 23	11
Sec. 41	11
Sec. 42	12
Sec. 43	12
Sec. 48	12
Miscellaneous:	
Treasury Regulations 77, Art. 322	8
Treasury Regulations 94:	
Art. 41–2	8, 13
Art. 43–1	14
Art. 43–2	15

616675—44——1

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 612

SPENCER, WHITE & PRENTIS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 78–91) is not reported. The opinion of the Circuit Court of Appeals (R. 265–269) is reported in 144 F. 2d 45.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 27, 1944 (R. 271). The petition for a writ of certiorari was filed on October 19, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Taxpayer, keeping its books and filing its returns on the accrual basis, was obligated to perform certain additional work in completing a contract, for which it would not be further reimbursed. However, no liability for the necessary labor and materials had been incurred. The question is whether taxpayer is entitled under Sections 23 (a) and 43 of the Revenue Act of 1936 to deduct the estimated cost of future performance as an expense incurred during the taxable year.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations appear in the Appendix, *infra,* pp. 11–15.

STATEMENT

Taxpayer is a New York corporation organized in 1919 and engaged in the general construction and engineering business. Its books have always been kept and its returns made on the accrual basis, and for fiscal years beginning July 1 and ending June 30. (R. 78, 79.)

The majority of the contracts received by taxpayer were short-term contracts completed within one year, but it was also interested in various long-term contracts. On December 11, 1933, it applied to the Commissioner of Internal Revenue for consent to change its method of accounting and reporting in connection with long-term con-

tracts to the completed contract basis. The application was disapproved because it was not submitted within the requisite 90-day period after the beginning of the taxable year. (R. 79.)

On June 29, 1937, taxpayer entered into a "unit price" contract with the City of New York for subway construction, and commenced performance in July of that year. Taxpayer was engaged in work on this contract (designated as No. 761 on its books) and on other contracts during the fiscal year ending June 30, 1938. The contract required the performance of thousands of types of operations, only some of which, known as "pay items," had specified prices. Taxpayer included in its bid price for the so-called pay items the cost of performing operations not specified as pay items, thereby distributing the cost of performing non-pay items over the pay items. The non-pay items included such things as the taking up and relaying of sidewalks, water mains and gas pipes, and general administration and engineering expenses. (R. 79–80.)

The contract provided for progress payments to taxpayer based upon certified partial estimates, to be made from time to time by the city engineer, of the value of the work done and materials incorporated in the work. The first certification of work completed was made approximately three months after work was started and certifications were generally made each month thereafter. The

contract was subject to a performance bond and as further security provided for retention by the city of 15% of the amounts certified. (R. 80–81.)

There was no separate certification by the city of work completed as of June 30, 1938, but there were certified estimates as of June 11, 1938, and July 11, 1938. Taxpayer included in its gross income returned for the fiscal year ending June 30, 1938, the sum of $3,853,641.43, made up as follows: (1) $3,002,303.34, representing the amounts certified and paid to June 11, 1938; (2) $529,818.24 representing the percentage retained by the city out of the amounts certified to that date; and (3) $321,519.85, representing the amount earned from June 11, 1938, to June 30, 1938. The last figure was reached on the basis of the certifications of work completed as of June 11, 1938, and July 11, 1938, respectively, and on the basis of the number of working days between June 11 and June 30. (R. 81–82.)

The total of $3,853,641.43 certified for the fiscal year ending June 30, 1938, and included by taxpayer as gross income in its return for that year covered not only the contract price of "pay items" completed, but some non-pay items yet to be performed. This resulted from the fact that the cost of non-pay items was included in the contract price of the pay items. Taxpayer estimated that the future cost of performing these uncompleted operations would total $327,500. (R. 82–83.) As

of June 30, 1938, under the caption "Contract 761 Deferred," taxpayer entered on its journal the following as "for incurred expense" (R. 83):

1. Moving off job, clean up, etc., 60% of $100,000		$60,000.00
2. Repairs to buildings damaged by subway construction and legal expenses, etc		50,000.00
3. Completion of excavation by removing braces, timbering, sheeting, installing backfill, 91,500 yards @ 1.25		114,500.00
4. Restoration of subsurface structures, damages vault construction		40,000.00
5. Clean up of East Tunnel Caulking		15,000.00
6. Supervision, office expenses for 3 mos.		
Electricians, mechanics	$5,000 per mo.	
Overhead	10,000 per mo.	
Office expense	1,000 per mo.	
	$16,000×3	48,000.00
Total		$327,500.00

The above total of $327,500 was reported on Schedule N (Balance Sheet) of taxpayer's return as "Liability to restore property under contracts." It was also included in the cost of operations in Schedule A (Net Income Computation), with a resulting diminution in net income for excess profits tax computation. (R. 83.)

The sum of $327,500 deducted for "incurred expense" did not represent obligations to subcontractors, materialmen, laborers, or any other creditor. The work was actually performed after June 30, 1938, at a cost of $339,090.40. Taxpayer had estimated that as of June 30, 1938, the contract was 60% completed; after actual completion it was found that it was then 53.9% completed. (R. 83.)

Taxpayer's costs under the construction contract paid and accrued to June 30, 1938, apart from the $327,500 entered on its journal as above, amounted to $2,860,110.76. In its return for the fiscal year ended June 30, 1938, taxpayer, in addition to deducting that amount, treated the $327,500 estimated cost of future work as an accrued expense and also deducted that sum from its gross income for that year. The Commissioner disallowed the $327,500 deduction for future expenses and computed a deficiency in taxpayer's income and excess profits tax in the amounts of $71,828.41 and $34,049.38, respectively. (R. 39–43, 83–84.) The Tax Court sustained the Commissioner's determination (R. 92), and the Circuit Court of Appeals affirmed (R. 270–271).

ARGUMENT

1. Taxpayer's assertion (Pet. 6) that the decision below is "probably in conflict" with decisions of this Court is without substance. To reflect taxable income on the accrual basis for a given year "all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid." *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, 519; see also *Security Mills Co.* v. *Commissioner,* 321 U. S. 281; *Brown* v. *Helvering,* 291 U. S. 193; *Lucas* v. *Ox Fibre Brush Co.,* 281 U. S. 115; *Lucas* v. *American Code Co.,* 280 U. S. 445. Neither *United States* v. *An-*

derson, 269 U. S. 422, nor *American National Co.* v. *United States,* 274 U. S. 99, upon which taxpayer relies (Pet. 7–8), holds otherwise. In the *Anderson* case it was held that a liability for a munitions tax had been incurred in the year prior to assessment because (269 U. S. at p. 441) all the events had occurred in that year which fixed the taxpayer's liability to pay the tax and its amount. Similarly, in the *American National Company* case a bonus expense was held deductible because the taxpayer's obligation to pay and the amount payable became definite in the year of deduction. Both of these cases were distinguished by this Court in *Lucas* v. *Ox Fibre Brush Co.,* 281 U. S. 115, and *Lucas* v. *American Code Co.,* 280 U. S. 445; they were cited in *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, 519, note 6, as illustrative of the long settled principle there reaffirmed. Where, as in the instant case, the items deducted represented an estimated amount of anticipated expenses to be incurred in furnishing work and materials in a later year (R. 82–83), not even the fact of liability is established and the deduction is clearly premature. There was no existing debt to accrue.

That taxpayer was obligated to furnish the work and materials to the City of New York without further compensation does not, as it urges (Pet. 8, 10–11), warrant an offsetting deduction in the taxable year of the estimated future expense of performance, for it is fundamental that income

616675—44——2

is to be determined and taxed on an annual, not a transactional, basis. *Security Mills Co.* v. *Commissioner,* 321 U. S. 281; *Heiner* v. *Mellon,* 304 U. S. 271; *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. This principle requires that payments received under a claim of right and without restriction as to their use be reported by a taxpayer on the accrual basis in the year received, notwithstanding that he may later be required to restore the payments or their equivalent. *North American Oil* v. *Burnet,* 286 U. S. 417; *Brown* v. *Helvering,* 291 U. S. 193. By the same token, the taxability of a payment for services may not be defeated by cutting across annual accounting periods and relating back expenses incurred in a later year in performing the services. *Clay Sewer Pipe Ass'n* v. *Commisioner,* 139 F. 2d 130 (C. C. A. 3d); *Amalgamated Housing Corp.* v. *Commissioner,* 37 B. T. A. 817, affirmed, 108 F. 2d 1010 (C. C. A. 2d). Neither items of income nor outgo may be accelerated or postponed in order to reflect the net result of a given transaction. *Security Mills Co.* v. *Commissioner,* 321 U. S. 281.[1]

---

[1] Permission to change from the accrual to the "long-term contract" method of accounting may, under certain conditions, be granted by the Commissioner. See Article 41–2 of Treasury Regulations 94 under the 1936 Act (Appendix, *infra,* pp. 13–14). Taxpayer in 1933 applied for such permission under the corresponding Article 322 of Treasury Regulations 77 under the 1932 Act, but the application was denied because not timely filed (R. 79, 214–217, 252–258).

2. The decision below does not conflict, as taxpayer alleges (Pet. 9–10), with *Bonded Mortgage Co.* v. *Commissioner,* 70 F. 2d 341 (C. C. A. 4th), *Ohmer Register Co.* v. *Commissioner,* 131 F. 2d 682 (C. C. A. 6th), *Air-Way Electric Appliance Corp.* v. *Guitteau,* 123 F. 2d 20 (C. C. A. 6th), or *United States* v. *Amalgamated Sugar Co.,* 72 F. 2d 755 (C. C. A. 10th.) The extracts cited from those decisions merely express the general principles of accrual which were followed by the court below.

3. Taxpayer attempts (Pet. 12–13) to inject a question concerning the amount of gross income to be reported. The only issue raised by the Commissioner's deficiency notice (R. 39–43) and the pleadings, and to which the Tax Court addressed itself (R. 84), was the propriety of the claimed deduction. The Tax Court did volunteer the suggestion that taxpayer might have overstated gross income by including in payments received from the city amounts certified but withheld as security (R. 84), but taxpayer insisted that it correctly reported gross income (R. 84–85). The Tax Court held that the deduction was not allowable in any event (R. 87). The Circuit Court of Appeals likewise addressed itself (R. 267) to the single issue raised by the Commissioner's disallowance of the deduction.

4. There is no merit in taxpayer's contention (Pet. 13–15) that the Tax Court's findings of fact

are unsupported by substantial evidence. The material facts are not in dispute. As the court below pointed out (R. 269), "The contention seems to rest on a confusion of facts with conclusions of law."

5. Taxpayer's assertion (Pet. 15–17) that this case presents an important question is predicated upon nothing more than the suggestion that the decision below is not in accord with the comment by an author of a text on taxation, whose cited views concerning Section 43 of the Revenue Acts are inconsistent with *Security Mills* v. *Commissioner,* 321 U. S. 281.

CONCLUSION

There is no occasion for further review. The decision below is controlled by settled principles of tax accounting. Neither a conflict of decisions nor a question of general importance is presented. The petition should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
HARRY BAUM,
Special Assistants to the Attorney General.

NOVEMBER 1944.